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No. 87-159

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1987

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THE OHIO CASUALTY INSURANCE COMPANY,
*Petitioner*,

v.

DOWNEY SAVINGS AND LOAN ASSOCIATION,
*Respondent*.

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**On Petition for Writ of Certiorari to the Court of Appeal of California, Second Appellate District**

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## MOTION FOR LEAVE TO FILE BRIEF OF AMICUS CURIAE, AND BRIEF OF AMICUS CURIAE, THE WASHINGTON LEGAL FOUNDATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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## MOTION FOR LEAVE TO FILE BRIEF OF AMICUS CURIAE, THE WASHINGTON LEGAL FOUNDATION

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The Washington Legal Foundation hereby moves this Court pursuant to Supreme Court Rules 36.1 and 42.2(b) for leave to file the annexed Brief of Amicus Curiae in support of the Petition for Writ of Certiorari in this case. This motion is required because the respondent in this case, Downey Savings and Loan Association, has refused to give its consent for the filing of this brief. The petitioner, Ohio Casualty Insurance Company, has consented to the filing of this brief. This motion and brief is timely filed since, although the respondent filed its brief early on August 19, 1987, the time allowed for its filing

is August 24, 1987, the petition for certiorari having been received by respondent on July 24, 1987. *See* Supreme Court Rule 22.1.

## INTERESTS OF AMICUS CURIAE

The Washington Legal Foundation, Inc. (WLF) is a non-profit tax-exempt corporation organized and existing under the laws of the District of Columbia for the purpose of engaging in litigation and the administrative process in matters affecting the broad public interest. WLF has more than 200,000 members, contributors and supporters throughout the United States whose interests the Foundation represents.

WLF participates in and has devoted a substantial portion of its resources to cases relating to government regulations and constitutional law. WLF has appeared as *amicus curiae* in a number of cases dealing with the constitutional rights of businesses and individuals. *See, e.g., Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979); *Consolidated Edison Company v. Public Service Commission*, 447 U.S. 530 (1980); *Pacific Gas & Electric Company v. The Public Utilities Commission of the State of California*, 106 S. Ct. 903 (1986); *Tull v. United States*, 107 S. Ct. 1831 (1987).

In addition to these cases, WLF has been concerned with the growing abuse of the awards of punitive damages and the deleterious effect that such awards have on the economy and consumers. In that regard, WLF recently published a monograph on the subject, J. Sales, *Punitive Damages: The Doctrine of a Bygone Era* (1984) surveying the historical and current practices of the award of punitive damages.

Finally, amicus raises an additional issue not covered by the parties, *viz.*, that the prerequisites for the imposition of punitive damages were never met, although that issue is part of the due process argument.

Accordingly, amicus respectfully requests that it be permitted to file the annexed brief which we believe will assist the Court in the disposition of this case.

Respectfully submitted,

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TABLE OF CONTENTS


| | Page |
|---|---|
| INTERESTS OF AMICUS CURIAE | 1 |
| STATEMENT OF THE CASE | 1 |
| REASONS FOR GRANTING THE WRIT | 6 |
| I. THE DUE PROCESS CLAUSE OF THE FOURTEENTH AMENDMENT PROHIBITS THE PUNISHMENT OF A PERSON IN THE FORM OF ASSESSING PUNITIVE DAMAGES WHERE THERE WERE NO CLEAR STANDARDS DELINEATING THE PROSCRIBED CONDUCT | 6 |
| II. THE AWARD OF PUNITIVE DAMAGES OF $5 MILLION WHERE NO ACTUAL DAMAGES WERE ASSESSED FOR THE TORT REPRESENTS A RATIO OF PUNITIVE TO COMPENSATORY DAMAGES OF INFINITY TO ONE IN VIOLATION OF CALIFORNIA LAW AND DUE PROCESS | 9 |
| III. THIS COURT SHOULD DETERMINE WHETHER PUNITIVE DAMAGES ARE SUBJECT TO THE EXCESSIVE FINES CLAUSE OF THE EIGHTH AMENDMENT | 17 |
| CONCLUSION | 19 |
| APPENDIX | |

## TABLE OF AUTHORITIES


| *Case* | Page |
|---|---|
| *Aetna Life Ins. Co. v. Lavoie*, 106 S.Ct. 1580 (1986) | 19 |
| *Banker Life and Casualty Co. v. Crenshaw*, No. 85-1765 (prob. juris. noted March 9, 1987) | 18 |
| *Brandt v. Superior Court* (1983), 37 Cal. 31, 813, 210 Cal. Rptr. 211, 693 P.2d 796 | 13, 14, 15, 16 |
| *Bundo v. Old Equity Life Ins. Co.*, 552 F.2d 1297, 1300 (9th Cir. 1981) | 11 |
| *Curtis v. Loether*, 415 U.S. 189 (1974) | 18 |
| *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 151 Cal. Rptr. 482, 620 P.2d 141, 15 (1979) | 10, 17 |
| *Gertz v. Robert Welch, Inc.*, 418 U.S. 349 (1974) | 17 |
| *Godfrey v. Georgia*, 446 U.S. 420 (1980) | 7 |
| *Grosjean v. American Press Co.*, 297 U.S. 233 (1936) | 6 |
| *Ingraham v. Wright*, 430 U.S. 651 (1977) | 18 |
| *Kolender v. Lawson*, 461 U.S. 352 (1983) | 7 |
| *Rosenbloom v. Metromedia, Inc.*, 403 U.S. 29 (1971) | 7, 18 |
| *Silberg v. California Life Insurance Co.* (1974), 11 Cal.3d 452, 113 Cal.Rptr. 711, 521 P.2d 1103 | 10, 12 |
| *Smith v. Wade*, 461 U.S. 30 (1983) | 7 |
| *Trop v. Dulles*, 356 U.S. 42 (1958) | 18 |
| *Tull v. United States*, 105 S.Ct. 1785 (1987) | 18 |
| *Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 503 (1982) | 7 |
| *Constitutional Provisions* | |
| Eighth Amendment | 17, 18, 19 |
| Fourteenth Amendment | *passim* |
| *California Statutes* | |
| Cal. Civ. Code § 3294 | *passim* |
| Cal. Ins. Code § 790.03(h) (5) | 9 |
| Cal. Ins. Code § 790.07 | 9 |

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## BRIEF OF THE AMICUS CURIAE THE WASHINGTON LEGAL FOUNDATION

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### INTERESTS OF AMICUS CURIAE

The interests of amicus curiae are set forth in the foregoing motion and are incorporated herein.

### STATEMENT OF THE CASE

In the interests of judicial economy, *amicus* adopts by reference the statement of the case as presented in the petition for writ of certiorari at 3-10. Nevertheless, *amicus* wishes to emphasize certain pertinent facts that may assist the Court in understanding this case.

1. In February 1973, petitioner Ohio Casualty Insurance Company ("Ohio") issued a fidelity bond to respond-

ent Downey Savings and Loan Association ("Downey") promising to *indemnify* Downey for *losses* up to $3 million incurred as a result of "any dishonest fraudulent act" of Downey's employees. *See* Opinion of Court of Appeal of California, Second Appellate District, reprinted in Appendix to Petition for Certiorari at 2a (hereinafter "Pet. for Cert.") The bond also promised to indemnify Downey for attorney's fees and court costs incurred by Downey in defending any lawsuit brought by a third party who may have suffered an economic loss because of the dishonest conduct of any of Downey's employees. *Id.* Instead of having to pay Downey's attorney's fees, the indemnity agreement contained a clause giving Ohio the *option* to defend any suit that may be filed against Downey by a person claiming a loss due to the dishonest act of Downey's employees.

2. In late 1974 and early 1975, several individuals concocted a scheme whereby certificates of deposit were to be purchased from Downey with worthless checks, and then the certificates would be used as collateral for obtaining loans from an unsuspecting third-party, American Funding Corp ("AFC"). It appears that one Downey employee was involved in this scheme, although the exact nature of his involvement was unclear at the time.

3. Before the scheme was uncovered, the individuals were able to purchase a $100,000 certificate from Downey with a worthless check and were then able to obtain a loan for that same amount from AFC by pledging the passbook reflecting the $100,000 certificate as security. American Funding subsequently called in its loan when it became due on January 8, 1976, was unable to collect from the maker, found the collateral or security to be worthless, and sued Downey in January 1976 for having wrongly assured American Funding that the $100,000 certificate was properly issued. Downey, however, had *not lost a single cent due to the scheme* since no funds of Downey's were actually embezzled or wrongly transferred. Downey was never bilked; AFC was.

4. In February, 1976, Ohio received a copy of the American Funding complaint against Downey but did not exercise its option to defend the suit, especially since Ohio believed that it may not even have to indemnify Downey at all since the conduct of Downey's employee in this scheme may not have been a dishonest act covered under the fidelity bond.[1] Regardless of the reasonableness of this belief, the fact remains that the option to defend was Ohio's, even assuming that the dishonesty of the Downey employee was clear. Accordingly, Ohio refused Downey's request that it be reimbursed for the attorney's fees heretofore incurred in defending itself against AFC's lawsuit.

5. On November 21, 1978, while the suit by AFC against Downey was still pending, Downey sued Ohio for indemnification even though Downey had *not* yet suffered any loss due to any dishonest act of its employees covered under the policy. As a separate cause of action, Downey alleged a breach by Ohio of an implied covenant of good faith and fair dealing. Downey sought compensatory damages under this tort cause of action for attorney's fees and costs incurred in *defending* the AFC lawsuit (the same amount that would be recoverable under the indemnity agreement), and punitive damages in the amount of $250,000 for Ohio's allegedly malicious manner in which it breached its duty of good faith.[2] Significantly, in its amended complaint Downey did *not* seek compensatory damages for any attorney's fees incurred in the *prosecution* of its suit against Ohio for the breach of good faith cause of action. *See* Appendix A hereto.

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[1] Indeed, 5 of the 12 jurors in the instant action believed that the Downey employee was innocent of any wrongdoing. Ohio's Opening Brief in Court of Appeal at p. 19.

[2] The amount of punitive damages was increased from $250,000 to $5 million by Downey in its Second Amended Complaint filed January 20, 1983. Attached hereto as Appendix A is the pertinent excerpt of the breach of good faith cause of action.

Rather, Downey alleged a right to recover fees and costs for prosecuting its action under its First Cause of Action for simple indemnity, which issue of damages, as will be discussed later, never went to the jury.

Although Downey had not yet suffered any loss, it sued on the grounds that Ohio had a duty *to defend* against a *potential* loss and not just a duty to *indemnify* for an *actual* loss as provided in the contract.

6. In February 1981, Downey settled the case with American Funding paying them $55,000 of the $100,000 claimed. As the court of appeal and even Downey itself recognized, Downey "did not suffer a loss [under the policy] until it paid American Funding $55,000 [in February, 1981] to settle the lawsuit. . . ." Pet. for Cert. 13a & n.1.

7. Assuming that the loss of $55,000 was due to a dishonest act covered by the policy, the extent of Ohio's liability under the policy was limited to the actual loss ($55,000) plus the attorney's fees and costs incurred by Downey to defend itself against the suit by American Funding ($68,769.75) for a total of $123,769.75.

8. On January 12, 1984, the jury awarded Downey the $123,769.75 (plus pre-judgment interest of $29,213.68) for the compensatory damages on the indemnity cause of action, and $5 million punitive damages for allegedly breaching in a malicious way a duty to act in good faith to defend Downey in the action brought by AFC, although the bond required only a duty to indemnify for actual losses. Significantly, the jury did *not* assess any compensatory damages for the breach of good faith cause of action. As will be discussed, those damages at best could include a portion of the attorney's fees Downey incurred in *prosecuting* its claims against Ohio, but not those fees previously incurred for defending the claim against it by American Funding.

9. The trial court had ruled that Downey's fees in prosecuting the action against Ohio were not recoverable and the issue never went to the jury. While the Court of Appeal reversed on this issue on February 26, 1987, the jury has yet to determine in this case the amount of any compensatory damages suffered by Downey on the bad faith claim upon which the $5 million in punitive damages was supposedly based.

In sum, the California courts in this case ruled:

(a) that the duty to indemnify henceforth includes the broader duty to defend;

(b) that Ohio breached this judge-made contractual provision of a duty to defend;

(c) that Ohio breached a judge-made implied duty sounding in tort to discharge in good faith its contractual duty to defend; and

(d) that Ohio did so not simply in an unreasonable way, but in such a way that was "malicious" justifying a record-setting award of $5 million in punitive damages.

Yet, the key undisputed facts are:

(a) the indemnity policy did not require Ohio to defend against potential losses, but only to indemnify for actual losses sustained;

(b) no actual loss covered by the policy was sustained by Downey until February, 1981 when they settled the AFC claim for $55,000;

(c) punitive damages were assessed for conduct by Ohio that occurred prior to any loss incurred by Downey and prior to any court ruling that the duty to indemnity would be judicially interpreted to include a broader duty to defend;

(d) punitive damages were awarded without the jury finding any compensatory damages suffered by Downey

for *tort* claim, *i.e.*, the breach of good faith cause of action upon which the punitive damages were supposedly to be based;

(e) the compensatory damages awarded by the jury were for the losses suffered by Downey due to the breach of contract claim; and

(f) California law expressly forbids the imposition of punitive damages for breach of contract claims. *Cal. Civ. Code* § 3294.

## REASONS FOR GRANTING THE WRIT

### I. THE DUE PROCESS CLAUSE OF THE FOURTEENTH AMENDMENT PROHIBITS THE PUNISHMENT OF A PERSON IN THE FORM OF ASSESSING PUNITIVE DAMAGES WHERE THERE WERE NO CLEAR STANDARDS DELINEATING THE PROSCRIBED CONDUCT.

*Amicus* submits that as a basic requirement of due process, no punishment can be imposed, nor a person's property deprived, without a clear standard specifying what conduct is prohibited. In this case, the defendant was severely punished to the extent of $5 million by a jury for breaching a duty to defend its insured from a potential loss even though the indemnity contract promised to pay only for an actual loss incurred.

It is well settled law that the Due Process Clause of the Fourteenth Amendment applies to corporations such as petitioner. *Grosjean v. American Press Co.*, 297 U.S. 233, 244 (1936). Accordingly, whatever due process law that is extant for individuals is equally applicable to corporations.

In addition, the Due Process Clause prohibits the deprivation of "life, liberty, or property without due process of law . . . ." While these three interests "life, liberty, or property" are textually equivalent, this Court has consistently recognized a greater or "super" due

process to be afforded in those cases involving the deprivation of "life," *i.e.*, capital punishment cases, than in deprivations of liberty or property. *Godfrey v. Georgia*, 446 U.S. 420 (1980). Accordingly, *amicus* submits that at a minmum, the due process requirements for the deprivations of property, which the assessment of punitive damages surely is, should at least be on a par with the protections afforded persons for deprivation of "liberty." This is especially so where, as here, the deprivation of "property" in the form of punitive damages is done for the purpose of punishment which to some degree limits the liberty that the person may otherwise enjoy in the use of his property. Indeed, by so "punishing" civil defendants, both their property and liberty are taken in a quasi-criminal context. As Justice Rehnquist, joined by former Chief Justice Burger and former Justice Powell stated:

> Although punitive damages are "quasi-criminal," *Huber v. Teuber*, 10 D.C. 484, 490 (1877), their imposition is unaccompanied by the types of safeguards present in criminal proceedings. This absence of safeguards is exacerbated by the fact that punitive damages are frequently based upon the caprice and prejudice of jurors. *Smith v. Wade*, 461 U.S. 30, 59 (1983) (Rehnquist, J., dissenting)

*See also Rosenbloom v. Metromedia, Inc.*, 403 U.S. 29, 82 (1971) (Marshall, J., dissenting) (punitive damages "serve the same function as criminal penalties").

Accordingly, petitioner is absolutely correct in asserting (Pet. for Cert. at 16) that before the State can punish a person, "fair warning of what is proscribed," *Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 503 (1982), must be given to avoid "arbitrary and discriminatory enforcement." *Kolender v. Lawson* 461 U.S. 352, 357 (1983). In this case, Ohio is being punished for conduct that did not at the time violate California law and was in accord with the con-

tractual agreement it had with Downey, *viz.*, to indemnify for *actual* losses, not defend against *potential* losses.

Nor does there seem to be any policy reason to extend the narrow duty to indemnify to a duty to defend. Normally, the duty to defend and to settle claims is specified as a duty in the insurance contract. The further implied duty to act in good faith to defend or settle claims brought by third-parties against the insured is to prevent the insured from being exposed to liability that may exceed the policy limits.

In the instant case, however, the maximum amount of potential loss to Downey was only $100,000, an amount well within the $3 million policy limit, even including coverage for attorney's fees and costs. Accordingly, if Downey was correct in its belief that the potential loss of $100,000 should be covered by the policy, there was no need to judicially broaden Ohio's duty to defend since no liability exceeding the policy limits was possible. Furthermore, Ohio investigated the claim for Downey's loss certainly after it was realized in February 1981. Whatever shortcomings of Ohio's investigation that occurred prior to 1981 of the inchoate claim [3] is simply irrelevant. More importantly, however, is that Ohio was not given "fair notice and warning" that it had a duty to defend as opposed to its contractual duty to indemnify. Consequently, Ohio's right to due process was violated.

In addition, there is no reasonable standard notifying persons what the range of the penalty may be. In this case, Downey was assessed a penalty of $5 million, an amount rarely imposed by courts as a fine for the most criminal of acts committed by an individual or corporation. Since a corporation cannot be imprisoned, the amount of

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[3] Although California Civil Code § 3294 permits punitive damages for "oppression, fraud, or malice" in non-contract cases, Downey alleged only "malice" on the part of Ohio in the amended complaint. *See* Appendix A hereto.

punishment meted out by criminal fine is coextensive to the amount of punishment meted out by a civil fine in the form of punitive damages. Yet the California legislature would criminally punish Ohio's behavior at best for $500 for not settling claims "in good faith." *Cal. Ins. Code* §§ 790.03 (h) (5), 790.07. In addition, insurance companies are heavily regulated industries and their license to practice can be revoked for improper insurance practices, a sanction akin to capital punishment. Since no action has been apparently taken against Ohio by the State of California in a way that was principally designed by the California legislature to regulate and punish the insurance companies for improper conduct, one must assume that the authorities of California do not view the conduct of Ohio to have been improper. Yet, a jury, acting as a mini-legislature and executive, determined in an ad hoc way that Ohio should be fined 5 million dollars, an amount that is one *million* per cent of the maximum criminal fine, and is merely a windfall to the plaintiff and its attorneys. The notion that the $500 maximum fine may not deter fails to take into account that the legislature has already made that policy decision, and that the more extreme punishment of license revocation, a form of "capital punishment," is more than sufficient to deter improper insurance practices.

## II. THE AWARD OF PUNITIVE DAMAGES OF $5 MILLION WHERE NO ACTUAL DAMAGES WERE ASSESSED FOR THE TORT REPRESENTS A RATIO OF PUNITIVE TO COMPENSATORY DAMAGES OF INFINITY TO ONE IN VIOLATION OF CALIFORNIA LAW AND DUE PROCESS.

In the instant case, the jury assessed a record-setting five million dollars in punitive damages against Ohio allegedly for breaching in a malicious way the implied covenant of good faith and fair dealing, a separate cause of action sounding in tort added by Downey to its original complaint for indemnity. However, the jury did not

award any compensatory damages to Downey for the breach of that implied covenant. Accordingly, the prerequisites for the award of punitive damages was not met, and under California law and the Due Process Clause, that part of the judgment must be vacated.

The compensatory damages of $123,769.75 awarded in this case is comprised of the $55,000 which represents the settlement reached by Downey with AFC, the third-party lender, as well as attorney's fees and costs incurred by Downey in *defending* against AFC's claim for $100,000. *See* Pet. for Cert. at 8 & n.2. That amount, therefore, merely represents the compensatory damages suffered by Downey for the simple breach of *contract* claim since the indemnity contract specifically covered those items as reimbursable losses. California law expressly prohibits the assessment of punitive damages for breach of contract regardless of how malicious the breach may have been.

> *Cal. Civ. Code* § 3294 (Deering Supp. 1976) (a) In an action for the breach of an obligation *not arising from contract*, where the defendant has been guilty of oppression, fraud, or malice, express or implied, the plaintiff in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant (emphasis added).

Although one might reasonably conclude that the breach of any implied covenant to act in good faith in discharging contractual obligations is a breach arising from the contract and therefore is not subject to punitive damages under Section 3294 of the California Civil Code, *see Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 819 151 Cal.Rptr. 482, 490, 620 P.2d 141, 151 (1979) (Clark, J., dissenting), the California Supreme Court has ruled that the duty to deal in good faith is an action sounding in tort. *Silberg v. California Life Insurance Co.*, 11 Cal.3d 452, 113 Cal.Rptr. 711, 521 P.2d 1103 (1974). Be that as it may, the only possible compensatory

damages suffered by Downey for the tort action, *i.e.*, the breach of good faith dealing, was the attorney's fees incurred by Downey to sue Ohio *to recover* the amounts due under the indemnity agreement, *not* the attorney's fees Downey incurred prior to that in *defending* its suit filed by the third-party lender. As for compensatory damages represented by the attorney's fees incurred by Downey in *prosecuting* its suit against Ohio for indemnity, the jury did not award Downey anything, since the trial court granted Ohio's trial motion and ruled that the attorney's fees and costs in *prosecuting* the suit was not recoverable. That *in limine* ruling was reversed and remanded by the court of appeal below (*see* Pet. for Cert. at 3a) and will be discussed later, but the fact remains that when the jury assessed a $5 million punitive damage award, it did so without awarding Downey any compensatory damages, not even nominal damages, *for the breach of good faith.* California law as well as the Due Process Clause prohibits the imposition of punitive damages when no compensatory damages are awarded, and such penalties are *per se* excessive when they approach, as they do here, a ratio of punitive damages to compensatory damages of infinity to one. *See Bundo v. Old Equity Life Ins. Co.*, 552 F.2d 1297, 1300 (9th Cir. 1981) ("California law requires that a punitive damage award bear relationship to compensatory damages . . . . Upon [absence of compensatory damages], the award for punitive damages also fails.")

Typically in an insurance case, the insured, usually an individual rather than a corporation as here, brings an action against the insurance company for failing to pay a claim that the insured believes is covered by the policy. If the jury simply finds that the loss was covered, the insurance company would of course be ordered to pay the claim for breach of contract. However, if the insured further proves that the insurer breached its duty of good faith in dealing with the insured, even in an unreason-

able way, the jury could award only compensatory damages for that tort, usually consisting of injury to feelings, emotional distress, mental anguish and the like. A mere violation of a duty of good faith and fair dealing "alone does not necessarily establish that defendant acted with the requisite [malice]." *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 113 Cal. Reptr. 711, 718, 521 P.2d 1103, 1110. In addition to those compensatory damages for mental distress, a jury could impose punitive damages only if they find the insurer acted not simply unreasonably, but fraudulently or maliciously in breaching its tort duty to act in good faith. Since California law prohibits the assessment of punitive damages for breach of contract claims, *Cal. Civ. Code* § 3294, the punitive damages in insurance bad faith cases would necessarily be assessed in relation to the injuries suffered by the *breach of the tort*, *i.e.*, damage to feelings, emotional distress, etc., and *not* the damages awarded for the breach of contract, *i.e.*, the amount of the original medical or automobile claim rejected by the insurer.

In the instant case, the plaintiff is not an individual but a corporation. As an artificial entity, a corporation cannot suffer emotional distress, anguish, and the like. Consequently, the only compensatory damages Downey could possibly suffer for Ohio's breach of good faith in failing to defend is what it cost Downey to get Ohio to live up to its contract, *i.e.*, certain attorney's fees and costs incurred for *prosecuting* its claim against Ohio and not for the loss of $55,000 and fees and costs incurred by Downey for *defending* itself against the AFC suit, since such costs are merely recoverable under the insurance contract as part of the covered loss, just as a medical or automobile claim may be covered in a typical policy owned by an individual.

The trial court in this case refused to allow Downey to recover any attorney's fees incurred in the prosecution of this very suit against Ohio, but was reversed by

the court of appeal below citing *Brandt v. Superior Court* (1983), 37 Cal. 31 813, 210 Cal. Rptr. 211, 693 P.2d 796. The following excerpt from the *Brandt* decision makes it clear, nevertheless, that only those attorney's fees reasonably incurred to prosecute the *contract* claim are compensable for the breach of good faith tort action:

> It is well settled that if an insurer, in discharging its contractual responsibilities, 'fails to deal *fairly and in good faith* with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.' (*Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566, 574 [108 Cal. Rptr. 480, 510 P.2d 1032], original italics.) When such a breach occurs, the insurer is 'liable for any damages which are the proximate result of that breach.' (*Neal v. Farmers Ins. Exchange* (1978) 21 Cal.3d 910, 925 [148 Cal.Rptr. 389, 582 P.2d 980].)" (*Austero, supra*, 132 Ca.App.3d at pp. 419-420, 182 Cal.Rptr. 919 [dis. opn. of Morris, P.J.].)
>
> When an insurer's tortious conduct reasonably compels the insured to retain an attorney *to obtain the benefits due* under a policy, it follows that the insurer should be liable in a tort action for that expense. The attorney's fees are an economic loss—damages—proximately caused by the tort. (*Mustachio v. Ohio Farmers Ins. Co., supra*, 44 Cal.App.3d at p. 363, 118 Cal.Rptr. 581) (Emphasis added). These fees must be distinguished from recovery of attorney's fees *qua* attorney's fees, such as those attributable to the bringing of the bad faith action itself. What we consider here is attorney's fees that are recoverable as damages resulting from a tort in the same way that medical fees would be part of the damages in a personal injury action.

37 Cal.3d 813, 817, 210 Cal. Rptr. 211, 213, 693 P.2d 796, 798.

The *Brandt* court had stated the issue before it thusly:

> "When an insurer tortiously withholds benefits, are attorney's fees, *reasonably incurred to compel payment of the policy benefits*, recoverable as an element of the damages resulting from such *tortious* conduct? [4] We hold that they are. . . ." 210 Cal. Rptr. at 212, 693 P.2d at 797 (emphasis added).

As the quoted passage indicates, the *Brandt* court was careful to note that only those attorney's fees which were necessary to bring suit on the contract claim are recoverable as damages for the bad faith claim, as opposed to those attorney's fees incurred for that part of the lawsuit devoted to the tort claim itself, *i.e.*, the breach of good faith (as well as the legal effort that went into proving punitive damages). Clearly, if *all* of the attorney's fees and costs incurred in the suit by Downey against Ohio were allowed, then Downey would be impermissibly recouping a large amount of attorney's fees *qua* attorney's fees for that portion of its legal efforts associated with the tort action, and thus would violate the American rule on attorney's fees.

Assume, in other words, that Downey had brought two separate suits against Ohio, the first one for breach of contract or indemnity and a subsequent one for tort, *i.e.*, for breach of good faith and fair dealing. In the first contract action, Downey could only recover the amount determined to be due under the policy, *i.e.*, the loss incurred ($55,000) and fees and expenses incurred by Downey in *defending* that loss which the policy expressly stated would be covered. No attorney's fees for *prosecuting* this simple contract suit, however, would be recoverable since such an award would violate the American rule that each party bear their own attorney's fees.

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[4] The *Brandt* court in footnote 1 of its decision cautioned that it was not deciding "*when* it is reasonable to incur such fees "(emphasis in original) but merely whether reasonable fees are recoverable. *Id.*

And certainly no punitive damages would be allowed. *Cal. Civ. Code* § 3294. However, in the second subsequent lawsuit for the tort action of breach of good faith, the compensatory damages, according to *Brandt*, are only those expenses the insured incurred to obtain its payments from the insurer, *i.e.*, the attorney's fees incurred for prosecuting the original breach of contract lawsuit. However, no attorney's fees for the subsequent tort suit itself would be recoverable because then again, attorney's fees *qua* attorney's fees are not recoverable under the American rule. Any punitive damages in the tort action must necessarily be based therefore only on the amount of the compensatory damages, *i.e.*, the attorney's fees incurred to prosecute the *contract* action.

In the instant case, the two lawsuits were brought as one but the rules for determining compensatory damages for the breach of good faith remain the same as if two separate suits were brought. In this case, *no* attorney's fees for prosecuting the suit against Downey were ever assessed by the jury, and consequently no compensatory damages were awarded for the breach of good faith. Accordingly, the punitive damage award was improper as a matter of law. Even on remand, the amount of the attorney's fees that can be assessed is severely limited and does not include all of the fees incurred as a result of Downey suing Ohio. As the *Brandt* court concluded, such a sophisticated determination of determining attorney's fees as compensatory damages—fees allocable to the bringing the contract portion of the suit but awardable as damages for the tort portion cause of action—is best left to the trial judge, but if

> however, the matter is to be presented to the jury, the court should instruct along the following lines: "If you find (1) that the plaintiff is entitled to recover on his cause of action for breach of the implied covenant of good faith and fair dealing, and (2) that because of such breach it was reasonably neces-

> sary for the plaintiff to employ the services of an attorney to collect the benefits due under the policy, then and only then is the plaintiff entitled to an award for attorney's fees incurred *to obtain* the policy benefits, *which award must not include attorney's fees incurred to recover any other portion of the verdict.*" 653 P.2d at 790 (Emphasis added)

Only when the trial court in this case, or a jury if it is utilized, determines the compensatory damages for the breach of good faith, *i.e.*, the attorney's fees incurred for the contract portion of the suit, will the court or jury be in a position to determine what, if any, punitive damage should be awarded.[5] Until that happens, however, the punitive damage judgment in this case is void and must be set aside.

It only makes sense that the claim for the loss allegedly covered by the contract *not* be included as a measure for punitive damages. Assume the present facts in this case except instead of "purchasing" the $100,000 certificate from Downey, the con men purchased $1,000,000 and were able to get a loan in that amount from AFC. Why should the amount of the subsequent but covered loss be a basis upon which to inflate the punitive damages? Ohio did not cause the $1,000,000 loss in this hypothetical, one of Downey's employees did. Yet the California court, assuming that a ratio of punitive to compensatory damages of approximately 40 to 1 is reasonable, would sustain a staggering $40 million punitive damage award in that situation for precisely the same conduct Ohio undertook when only $100,000 was at stake and when presumably Downey's attorney's fees and cost would be

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[5] Not only is the amount of attorney's fees that may be awarded limited to that incurred for the part of the contract action, there is also the question, as the *Brandt* court noted, *infra* note 5, as to *when* the fees were reasonably incurred. A jury may very well conclude that a suit for indemnification filed more than two years *before* the actual loss was incurred (*i.e.*, while the suit by AFC against Downey was still pending) was unreasonable.

the same in both cases. In such a situation, an insurance company would be discouraged from carefully investigating and asserting defenses against huge claims for fear that such conduct might be construed as a breach of good faith and fair dealing resulting in the assessment of a corresponding astronomical punitive damage award. The larger the disputed claim the larger the potential punitive damages and windfall to the insured.

By being effectively forced to pay questionable larger claims, the profitability of the insurance company decreases and the inevitable premium increase results. Thus, not only do the consumers ultimately bear the burden of the assessment of punitive damages in the form of higher premiums, *see Egan v. Mutual of Omaha Insurance Co.*, 24 Cal. 3d 809, 820, 169 Cal. Rptr. 691, 702, 620 P.2d 141, 150 (1979) (Clark, J., dissenting), consumers also pay by the threat of unlimited punitive damages which discourage the defense of huge claims, the very kind of claim that one would expect prudent businessmen to more carefully scrutinize. If the lower court's decision is sustained, then the Court will in effect permit the assessment of punitive damages for amounts suffered as a breach of contract which the California legislature has expressly forbidden. *Cal. Civ. Code* § 3294.

## III. THIS COURT SHOULD DETERMINE WHETHER PUNITIVE DAMAGES ARE SUBJECT TO THE EXCESSIVE FINES CLAUSE OF THE EIGHTH AMENDMENT.

In addition to the important questions of whether due process was satisfied in this case and whether punitive damages could be awarded, there is the further constitutional question of whether punitive damages, being penal in nature, are subject to the Excessive Fines Clause of the Eighth Amendment.

The penal nature of civil punitive damages has long been recognized. *See, e.g., Gertz v. Robert Welch, Inc.*,

418 U.S. 349, 353 (1974) ("punitive damages . . are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence"); *Rosenbloom v. Metromedia*, 403, U.S. 29, 82 (1971) (Marshall, J., dissenting).

In *Trop v. Dulles*, 356 U.S. 42 (1958), this Court ruled on whether a provision of the Nationality Act revoking the citizenship of anyone court martialled for desertion was a penal law. This Court "has generally based its determination upon the purpose of the statute. If the statute imposes a disability for the purpose of punishment—that is to reprimand the wrongdoer, to deter others, etc., it has been considered penal." 356 U.S. 86 (footnote omitted). By this logic, and the clear purpose of punitive damages as authorized by most States, the similarity between the Excessive Fines Clause of the Eighth Amendment and punitive damages appears compelling.

As noted in *Ingraham v. Wright*, 430 U.S. 651, 669 n.37 (1977), "some punishments, though not labeled 'criminal' by the State, may be sufficiently analogous to criminal punishments in the circumstances in which they are administered to justify application of the Eighth Amendment."

Accordingly, just as the Supreme Court recently reaffirmed that the Seventh Amendment right to a jury trial for suits at common law is applicable to modern civil actions which did not exist in 1789, *Tull v. United States*, 105 S.Ct. 1785 (1987); *Curtis v. Loether*, 415 U.S. 189 (1974), so too should the court determine whether punitive damages are subject to the Eighth Amendment.

While amicus is aware that this Court recently noted probable jurisdiction on the Eighth Amendment issue in *Bankers Life and Casualty Co. v. Crenshaw*, No. 85-1765 (prob. juris. noted March 9, 1987), amicus submits that

the instant case is one that is in an "appropriate setting" to consider the issue as stated by former Chief Justice Burger in *Aetna Life Insurance Company v. Lavoie*, 106 S.Ct. 1580, 1589 (1986).

## CONCLUSION

Because of the substantial federal questions implicated in the assessment of punitive damages in this case and others like it across the country, including whether it should have been assessed at all, the petition for writ of certiorari should be granted.

Respectfully submitted,

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Dated: August 24, 1987

## APPENDIX A

## (EXCERPT FROM DOWNEY'S SECOND AMENDED COMPLAINT DATED JANUARY 20, 1983)

### FOURTH CAUSE OF ACTION

(For Intentional Interference With Protected Property Interest And Breach of Covenant of Good Faith And Fair Dealing)

26. Plaintiff refers to and realleges paragraphs 1 through 18, inclusive, of the First Cause of Action, and paragraphs 19 through 22, inclusive, of the Second Cause of Action, and, by this reference thereto, incorporates them herein and makes them a part hereof as if they were fully set forth at length.

27. At all times herein mentioned, Defendant OHIO occupied a special relationship to Plaintiff, its insured, and has special implied-in-law duties toward plaintiff including, but not limited to, an implied-in-law duty and covenant of good faith and fair dealing that it do nothing to deprive Plaintiff of the benefit of its Bond and that it not withhold payments thereunder without probable cause.

28. At all times subsequent to October 31, 1977, Defendants knew or should have known the truth, accuracy and veracity of Plaintiff's claim, and had ample information and facts, including the transcript of the sworn testimony of an eye witness to and co-conspirator in the alleged fraudulent scheme and conspiracy, to enable it to verify and honor Plaintiff's claim.

29. Defendant OHIO breached and violated its implied-in-law duty and covenant of good faith and fair dealing by maliciously and without probable cause failing and refusing to assume the defense of the AFC lawsuit and/or to indemnify and pay Plaintiff on account of its

losses incurred including costs, attorneys fees, and losses, and by maliciously and without probable cause failing and refusing to admit coverage under the Bond for all losses including attorneys' fees that were caused by and resulted from the dishonest and fraudulent acts of McGREW.

30. As a direct, proximate and foreseeable result of Defendant OHIO's acts and omissions to act as hereinabove alleged, Plaintiff has been damaged in the sum of $123,779.65 together with past and continuing loss of use of said sum which Plaintiff was forced to expend as a direct and proximate result of defendant OHIO's acts and omissions to act as herein alleged.

31. In doing and omitting to do the things herein alleged, Defendant OHIO acted maliciously, recklessly and with a conscious disregard of the rights of Plaintiff and Defendant OHIO's obligations to Plaintiff, and with full knowledge that these acts and omissions to act would cause Plaintiff to incur losses, expenses and attorneys' fees as aforesaid, so that Plaintiff demands exemplary and punitive damages against Defendants, and each of them. Plaintiff does not now know the amount of punitive damages necessary to adequately punish and deter Defendant OHIO, but believes that amount to be in excess of $5,000,000.00 and will seek leave to amend this Complaint at or before trial at such time as the appropriate amount of damages has been ascertained.